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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
	)	

COMMENTS OF FOCAL COMMUNICATIONS CORPORATION

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SUMMARY

The revised proposal of the Coalition for Affordable Local and Long Distance Service ("CALLS"), far from providing "a clear path toward access charge and universal service reform," is an amalgam of arbitrary proposed departures from the price cap regulatory scheme that the Commission may not lawfully adopt absent substantial new rulemaking. The proposal to target X Factor reductions to traffic sensitive services would result in an unprecedented crazy quilt pattern of X Factors scattered throughout the price cap regulatory scheme. This proposed application of the X Factor is flatly inconsistent with the development of the X Factor as an industry wide measure of LEC productivity in comparison to the economy as a whole rather than as an estimation of productivity of individual services or baskets. The attached statement of Prof. Jeffrey I. Bernstein makes clear that there is no economic basis in the record for this proposed application of the X Factor.

The CALLS proposal also threatens to establish economically harmful incentives for both regulated companies and their customers by arbitrarily setting X Factors for baskets and services. The proposal would also grant premature pricing flexibility to ILEC members of CALLS by permitting them to achieve pricing flexibility by targeting X Factor reductions to specific services or baskets, regardless of the productivity of the targeted service or basket, in response to competition.

There is no record support that the proposed new universal service fund has any meaningful relationship to the goal of removing implicit support from interstate access charges. The size of the fund is completely arbitrary.

For these reasons, the Commission should reject the CALLS proposal.

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COMMENTS OF
FOCAL COMMUNICATIONS CORPORATION

Focal Communications Corporation ('Focal") submits these comments concerning the revised proposal of the Coalition for Affordable Local and Long Distance Service ("CALLS").[3] Focal is a rapidly growing facilities-based communications provider offering innovative data and voice services to large corporations, value-added resellers and Internet service providers in major markets nationwide.

I. INTRODUCTION

CALLS describes its proposal as providing "a clear path toward access charge and universal service reform."[4] In reality, the CALLS plan would subvert price cap regulation by converting arbitrarily the X-Factor from a carefully crafted measure of LEC productivity into a tool to obtain premature pricing flexibility and harm competition. CALLS also seeks to insulate

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[3] *Coalition for Affordable Local and Long Distance Service Modified Proposal*, Public Notice, CC Docket Nos. 96-262, 94-1, 99-249, 96-45, DA 00-533, released March 8, 2000.

[4] Memorandum in Support of the Revised Plan of the Coalition for Affordable Local and Long Distance Service, p. 5 ("Memorandum").

ILEC revenues from genuine access reform by shifting them from interstate access charges to an arbitrary universal service fund. The Commission should reject the CALLS proposal.

II. THE PROPOSED TARGETING OF X FACTOR REDUCTIONS TO SWITCHING IS ARBITRARY AND UNLAWFUL

A. The X Factor Is Measure of LEC Productivity As A Whole - Not A Source of Rate Reductions Available for Application Anywhere In the Price Cap Scheme

The X Factor embodies the Commission's assessment of the extent to which the productivity of the LEC industry as a whole has, in the past, exceeded the productivity of the general economy.[5] The Commission has determined that use of an industry-wide average productivity factor is consistent with the goal of creating price regulation that replicates the incentives provided by competition.[6] The Commission has consistently based the X-Factor on an industry-wide assessment of productivity. It did so when it initially developed the X-Factor in 1990, when it represcribed the X-Factor in the 1995 *LEC Price Cap Performance Review Order*,[7] and when it set the X-Factor at 6.5% in 1997.[8] The Commission has proposed to maintain that

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5 *Policy and Rules Concerning Rates for Dominant Carriers*, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990)("*LEC Price Cap Order*"); *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, 10 FCC Rcd 8961, 9027 ("*Price Cap Performance Review Order*").

6 *Price Cap Performance Review Order*, 10 FCC Rcd 9027.

7 *Id.*

8 *Price Cap Performance Review for Local Exchange Carriers, Fourth Report and Order*, CC Docket No. 94-1, 12 FCC Rcd 16642 (1997) (basing revised X-Factor on Total Factor Productivity ("TFP"), a methodology used to measure productivity and productivity growth in the economy as a whole).

approach in current X-Factor proceedings on remand from the DC Circuit.[9] There has been broad support throughout this proceeding to base the X-Factor on an industry-wide measure of performance.[10]

Except for the interexchange basket, the Commission has never sought to identify separate productivity factors for the various ILEC price cap baskets.[11] This would involve a substantially new and complicated enterprise which the Commission has never sought to undertake. Nor is there any information in the record of this proceeding that could provide a basis for determining separate productivity factors for the various price cap baskets, much less prescribing any such basket-specific X-factors. The Commission has heretofore applied the same X-Factor to the common line, trunking, and traffic sensitive baskets.[12] In short, the X-Factor has

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[9] *USTA v. FCC*, 188 F.3d 521 (D.C. Cir. 1999); *Price Cap Performance Review for Local Exchange Carriers*, CC Docket Nos. 94-1; *Access Charge Reform*, CC Docket No. 96-262, Further Notice of Proposed Rulemaking, FCC 99-345, released November 15, 1999, para 7 ("*X Factor Remand NPRM*").

[10] *Id.*

[11] Current rules set the X-Factor for the interexchange basket at 3%. The interexchange service is not an exchange access service and the 3% productivity factor applied to it is based on the 3% productivity factor formerly applied under price cap regulation of AT&T's interexchange services. *LEC Price Cap*, 5 FCC Rcd 6786, 6811 (1990). Accordingly, the Commission had an economic basis for setting the X Factor for the interexchange basket at 3%.

[12] *See* 47 C.F.R. Sections 61.45(b)(1) and (c). The Commission's rules set the X Factor for the now defunct video dialtone basket at 0%. 47 C.F.R. Section 61.45(b)(3). However, this reflected a decision by the Commission to not imprudently set a basket-specific X Factor for video dialtone without an adequate record.

> "Video dialtone differs from the provision of other LEC services in certain respects. For example, it serves different customers than other LEC services and uses different equipment to some extent. In the case of video dialtone, we have no record of industry or service productivity upon which to rely in setting the X-Factor. Until more information becomes available, we believe it is reasonable to set the initial X-Factor for the video dialtone basket at zero."

been developed exclusively as a measure of LEC productivity as a whole, not of individual LEC services and has been applied consistent with the X Factor's limitations as an industry-wide measure of productivity.

Because the X-Factor has been developed and applied as an industry wide measure of LEC productivity, Focal submits that the Commission may not employ the X Factor as a fungible source of rate reductions that may be applied anywhere in the price cap scheme regardless of the productivity gains of the baskets or services to which it is applied. Nor may the Commission employ X Factor reductions for purposes unrelated to and wholly apart from the legal and policy bases on which the X-Factor was developed in the first place.

However, as explained below, that is precisely what CALLS is asking the Commission to do. By targeting the X-Factor to specific baskets, and apparently even specific rate elements and services within baskets, it would effectively create a multiplicity of basket and service-specific productivity reductions without any justification or explanation as to how this would be consistent with price cap regulation, much less a justification based on productivity. While the Commission could establish basket- or service-specific X Factors based on a fully supported examination of past productivity of baskets and rate elements, it may not do so merely because some carriers have proposed or negotiated that result without any economic justification. Accordingly, the proposed targeting is unlawful.

In the Matter of Price Cap Performance Review For Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation, Second Report and Order and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 11098, 11102 (1995). The Commission should adopt the same prudent approach with respect to the CALLS proposal. The Commission should not permit ILECs to apply different X Factors to different baskets and services without an adequate record.

B. CALLS Has Provided No Economic Rationale For Its Proposed X-Factor Reductions

CALLS proposes a virtual crazy quilt pattern of X Factors within the ILEC price cap regulatory scheme. The plan would apply the dollar amount of X-Factor reductions that would otherwise apply to the common line, traffic sensitive, and trunking baskets only to the traffic sensitive and trunking baskets until an average target rate for those baskets is achieved.[13] This would, in effect, apply a zero productivity offset to common line and something on the order of an average reduction 12%[14] or more to trunking and traffic sensitive baskets until the target rates for switched services are achieved. In addition, ILECs could apply different X-Factor reductions to the trunking and special access baskets, and apparently even to different rate elements and services within baskets, as long as the average target price is achieved as measured across both of these baskets.[15] Special access would receive still another treatment - a 3.0% productivity reduction the first year, and then 6.5% until 2004.[16]

CALLS does not attempt to provide any explanation as to why the level of proposed productivity factors that would apply to various baskets and services under its proposal is appropriate to these respective price cap baskets and services. Indeed, given ILECs discretion to apply X Factor reductions to any rate element in the traffic sensitive or trunking baskets, there is

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13 The target rate is $0.005 for the Bell Operating Companies and GTE and $0.0065 for other ILECs choosing to participate in the CALLS plan. Modified Universal Service and Access Reform Proposal, Secs 3.1.2, 3.1.3 9 ("Proposal Description").

14 See the attached Declaration of Jeffrey Bernstein.

15 "Carriers, however, may take these reductions against any of the average traffic sensitive charge rate elements, provided that they still generate the same amount of reductions." Memorandum, p. 12.

16 Memorandum, p. 15.

no way of knowing at this point what X Factors would apply to various baskets and services under its proposal. Accordingly, this proposal is arbitrary on its face. The attached statement of Jeffrey I. Bernstein, Department of Economics, Carleton University makes clear that there is not a shred of economic theory or empirical evidence presented in the CALLS proposal for the differential application of X-Factors to price cap baskets and rate elements.

In short, CALLS' proposal for a multiplicity of X-Factor reductions is completely arbitrary and without any economic foundation. The Commission may not lawfully adopt it absent economic justification that the resulting X Factors are appropriate for the services and baskets in question. CALLS' unexplained and irrational proposal is not a sufficient basis for establishment of the bizarre pattern of X Factors that would result from its proposal. Again, if the Commission wishes to establish service or basket specific X Factors it may do so only after a rulemaking adequately supporting that result.

Focal also points out that the CALLS plan is also completely arbitrary with respect to its startling proposal to eliminate or substantially reduce X Factor rate reductions in the future. Thus, CALLS now proposes that after target rates for local switching are achieved the X-Factor would be set arbitrarily at GDP-PI. Thus, the X Factor would offset possible upward inflation adjustments but real productivity gains that LECs enjoy relative to the rest of the economy would not otherwise be passed on to consumers.[17] After target rates are achieved, there would apparently be no further X-factor rate reductions for the traffic sensitive or trunking baskets.[18] In addition, there would be no further X-Factor adjustments to common line rates on account of

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17 Proposal Description, Sec 3.2.1.

18 *Id.*

LEC productivity once target rates for switched services are achieved.[19] For special access, the X-Factor would be set equal to GDP-PI in 2004.[20]

CALLS has provided no explanation or justification for this virtual abandonment of X factor adjustments. Accordingly, in addition to the arbitrary targeting and resulting *pot pourri* of X-Factors that CALLS proposes, its proposal to substantially end X-Factor reductions is equally arbitrary and unlawful.

C. Previous Targeting to the TIC Does Not Justify the CALLS Proposal

In the *Access Reform Order*, the Commission required price cap ILECs to target X Factor reductions to the transport interconnection charge ("TIC").[21] This targeting does not establish a precedent for, or support, CALLS' proposed targeting of the X Factor to traffic sensitive charges. First, the Commission recognized that "the TIC adversely affects the development of competition in the interstate access market."[22] And, the Commission was seeking to eliminate the TIC in order to establish a rate structure for interstate access based on cost causation principles as directed in *Comptel*.[23] Thus this targeting was justifiable as necessary to remove an otherwise objectionable non-cost-based charge that thwarted the development of competition in the

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19 Proposal Description, Sec. 3.2.3.

20 *Id.* Sec 3.2.7.

21 *Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges*, Report and Order, CC Docket Nos 96-262, 94-1, 91-213, and 95-72, 12 FCC Rcd 15982, 16072-16086 (1997) ("*Access Reform Order*").

22 *Id.* at 16073.

23 *Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522 (D.C. Cir. 1996)("*Comptel*").

interstate access market and to meet the mandate of *Comptel*. CALLS is not able to support targeting of X Factor reductions to switching on this basis. Rather, the current rate structures, while perhaps imperfect in certain respects, reflect the rate structure improvements made by the Commission in the *Access Reform Order* that help assure that the rate structures for interstate access charges are in line with the way that costs are incurred.[24] Accordingly, it is not necessary to target X Factor reductions to local switching in order to phase out a non-cost-based rate structure.

More importantly, however, the targeting of the X Factor to the TIC did not involve an arbitrary selection of X Factors scattered throughout the price cap scheme. Instead, other baskets and charges governed by price caps receive no X Factor reductions until the TIC is eliminated. Thus, targeting of the X Factor to the TIC merely defers X Factor reductions for other rate elements and baskets until the TIC is phased out, and, therefore, does not involve application of different X Factor reductions to different price cap baskets. In addition, precisely because the TIC is a non-cost-based charge that was created primarily to preserve ILEC revenues after the termination of the equal charge per unit of traffic rule under the *Modified Final Judgment*, it does involve the potential economic distortions of arbitrary application of X Factors to other price cap baskets and services.[25] Again, CALLS' proposal could only rationally be

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[24] In the *Access Reform Order*, the Commission reformed "the current rate structure [of interstate access charges] to bring it into line with cost-causation principles .." *Access Reform Order*, 15998, para 35.

[25] *United States v. American Tel. and Tel. Co.*, 552 F.Supp. 131, *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983). The Modified Final Judgment established an interim rule that required, until September 1, 1991, BOC charges to IXCs to be "equal, per unit of traffic" of a given type transported between end offices and facilities of the IXCs within an exchange area or within reasonable subzones of an exchange area. 552 F. Supp 233-34. The Commission replaced the "equal charge" rule in 1993 with an interim rate structure for tandem

applied based on some economic showing that the proposed productivity reductions reflect the productivity of the services to which they are applied. Accordingly, TIC targeting does not justify, or provide precedent for, the CALLS proposal.

III. The Proposed Targeting Would Undermine Price Cap Regulation

Apart from the fact that CALLS has failed to provide any economic basis for establishment of the basket- and service-specific X Factors it proposes, this proposal entails a substantial risk of undermining the goals of price cap regulation. The price cap scheme is intended to promote efficient pricing of ILEC services while constraining ILEC ability to raise prices. However, CALLS' proposal to apply different X Factors with virtually no assurances that the proposed productivity offset is accurate for the baskets or services in question necessarily entails the possibility that a highly inaccurate productivity offset would be applied to a basket or rate element. This could seriously distort ILEC business marketing decisions and customers incentives and ability to purchase services.

The Commission has recognized the dangers in mis-setting the X-Factor:

> In a regulatory setting, if the TFP calculation sets the X-Factor too low, and, consequently, set prices too high, end users will purchase less of the services produced, and the quantity of output will be lower than if prices were set at a competitive level. The productivity of which the plant is capable will not be revealed. Since the marginal cost of additional output is believed to be very low in telecommunications, the effect on measured productivity may be large.[26]

In short, setting the X-Factor can seriously distort the economic incentives of regulated companies and their customers. And yet this is precisely what the CALLS proposal risks doing. Without knowing anything other than that the X-Factor measures LEC productivity as a whole,

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switched transport that included in part the TIC.

[26] *X-Factor Remand NPRM*, para. 14.

CALLS would impose a hair-brained scheme of different X-Factors to various price cap baskets without any reason to believe that those X-Factors would correctly apply to those services. Because this is arbitrary, the CALLS plan risks serious economic distortions by setting incorrect X-Factors. The Commission should reject the CALLS proposal for this reason as well.

IV. THE PROPOSAL WOULD GRANT PREMATURE PRICING FLEXIBILITY

In addition to the other highly problematic features of the CALLS proposal, it would also grant to its member ILECs sweeping premature pricing flexibility. As noted, the CALLS proposal would apparently permit ILECs to target X Factor reductions to any rate elements in the traffic sensitive or trunking baskets. CALLS has not attempted to provide any explanation as to why ILECs should be given this discretion to price services in this regard based on X Factor reductions.

While the Commission has removed price cap lower band pricing limits, it has not permitted ILECs to use X Factor reductions to do double duty: lowering prices to pass on productivity gains to customers and a mechanism for achieving pricing flexibility to meet competition. Focal submits that if ILECs want to reduce price cap indices to meet competition, they should not be able to do so by targeting X Factor reductions to particular rate elements and services. Besides being an abuse of the economic rationale underlying the X Factor as an industry wide measure of productivity, not individual services, this would permit ILECs to avoid the revenue reductions that other competitors must face when pricing to meet competition. Competitive providers must price lower to reflect productivity gains and meet competition because the marketplace requires it, but CALLS ILECs could simply shift overall productivity reductions to more competitive services within the traffic sensitive and trunking baskets while preserving revenues in other services even though those other services may be experiencing productivity gains that should be passed on to customers of those services under a rational application of the current X Factor. This proposal would therefor confer on ILECs a substantial market advantage that would harm competition.

The Commission has hereto granted ILECs the ability to price to respond to competition only after the careful evaluation of a complete record, and on the basis of a competitive showing.[27] While the Commission should never permit ILECs to use X Factor reductions to fund pricing flexibility, it would be patently unlawful for the Commission to adopt the CALLS ILECs pricing flexibility proposal at this stage in this proceeding merely on the basis of an ILEC negotiated proposal. The Commission is currently examining whether it should establish pricing flexibility for switched services.[28] Any pricing flexibility for these services should be established, if at all, on the basis of the Commission's proposals in that proceeding. Accordingly, the Commission should reject the CALLS pricing flexibility proposal.

V. THE PROPOSED UNIVERSAL SERVICE FUND IS ALSO ARBITRARY AND UNLAWFUL

CALLS proposes that the Commission establish a new $650 million universal service fund for the purpose of replacing interstate access service revenues that allegedly support universal service. CALLS states that this $650 million will replace "support that currently is implicit in interstate access charges."[29]

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[27] *Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, CC Docket No. 96-262, FCC 99-206, released August 27, 1999("*Pricing Flexibility Order*").

[28] *Pricing Flexibility Order*, *supra*.

[29] Memorandum, p. 3.

Focal fully supports removal of implicit support currently contained in interstate access charges. However, CALLS has not provided any basis to conclude that the proposed $650 million fund has any relationship to any implicit support contained in interstate access charges. This proposal is an attempt by CALLS to guarantee access revenues that may otherwise be lost with increasing competition by removing them from access charges and vesting them permanently in a universal service fund.

The Commission has conducted extensive proceedings to establish explicit universal service support.[30] In the *Universal Service Order*, the Commission determined that the appropriate level of federal universal service support should be based on forward-looking economic cost rather than embedded cost.[31] The Commission has observed that basing universal service support on embedded cost would send the wrong signals to potential market entrants and encourage inefficient entry.[32] The Commission also recognized that for purposes of administering a high cost support system based on forward looking cost, a model would be an essential part of determining support levels in an efficient way.[33] The Commission should use

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30 See, e.g. *Federal-State Joint Board on Universal Service Service*, Report and Order, 12 FCC Rcd 8776 (1997)("*Universal Service Order*"), as corrected by *Federal-State Board on Universal Service*, Errata, CC Docket No. 96-45, FCC 97-157, rel June 4, 1997); *Federal-State Board on Universal Service Service*, Fifth Report and Order, 13 FCC Rcd 21323 (1998)("*Platform Order*"); *Federal-State Board on Universal Service*, Ninth Report and Order and Eighteenth Order on Reconsideration, CC Docket No. 96-45, FCC 99-306 (rel. November 2, 1999)(methodology order); *Federal-State Board on Universal Service*, Tenth Report and Order, CC Docket No. 96-45, FCC 99-304 (rel. November 2, 1999)(inputs order).

31 *Universal Service Order*, 12 FCC Rcd at 8899, paras 224-25. see also *Federal-State Board on Universal Service*, CC Docket No. 96-45, *Recommended Decision*, 123 FCC Rcd 87 at 232.

32 *Platform Order*, p 21328, para. 10.

33 *Platform Order*, p. 21327, para. 9.

models developed in these proceedings, or other models, to determine the correct amount of implicit universal service support. Absent use of models, or ILEC cost studies, there is no way of knowing that the proposed plan does not base recovery on embedded costs.

CALLS suggestion that $650 million is the correct amount of support because AT&T has calculated that as the correct amount using the HCPM model is unconvincing.[34] CALLS also makes clear that its ILEC members are not endorsing $650 million as the correct amount of support based on models.[35] It also points out that other estimates of implicit support contained in interstate access charges based on economic models vary from $250 million to $3.9 billion. Thus, the CALLS proposal that $650 million is a reasonable estimate of implicit support contained in interstate access charges is little more than a self-serving totally arbitrary guess. Only in the context a fully supported explanation based on economic models could the Commission rationally determine the appropriate amount of implicit universal service support contained in access charges.

Moreover, because the ILEC members of CALLS disclaim any use of models,[36] Focal is very concerned that ILECs will subsequently walk away from this $650 million figure and argue that government programs masquerading as universal service should be increased above $650 million to protect even more ILEC interstate access revenues from competition.

Focal submits that the Commission may not lawfully establish this fund on the basis of the CALLS proposal. CALLS may be correct that establishing a set amount of $650 million sets

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34 Memorandum p. 10

35 Memorandum, p 10, n. 10.

36 *Id.*

a "specific" and "predictable" amount of explicit support.[37] However, these goals would only be achieved at the cost of an arbitrary and capricious selection by the Commission of $650 million as the amount of further universal support required under access reform goals and Section 254. The Commission should reject on the basis of the current record in this proceeding the proposed "universal service" fund as playing any useful or lawful role in genuine access reform.

[37] Memorandum p. 9

VI. CONCLUSION

For these reasons, Focal respectfully requests that the Commission deny the CALLS proposal.

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Dated: April 3, 2000

Statement Concerning Revised Plan of the Coalition for Affordable Local and Long Distance Service

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April 3, 2000

Under existing rules the Federal Communications Commission (FCC) regulates interstate access charges through a price cap mechanism. Price cap regulation typically specifies an average rate at which prices must decline, after adjusting for inflation. This rate is called the X factor, and currently it is set at 6.5% for common line, local switching, and switched transport price cap baskets.

The Coalition for Affordable Local and Long Distance Services (CALLS) has submitted a proposal to the FCC that includes amendments to switched access usage rates, subscriber line charges and universal service fund assessments. This declaration maintains that the CALLS proposal should be rejected. The proposal does not provide any quantitative economic evidence that it is consistent with sound economic principles and the objectives of the 1996 Telecommunications Act, to promote competition, and encourage the rapid deployment of new telecommunications technologies.

With respect to switched access usage rates, CALLS proposes (page 2, Memorandum in Support of the Revised Plan of the CALLS); "A \$2.1 billion reduction in switched access usage rates on July 1, 2000, if all companies participate, and a nearly 50% reduction in switched access rates over five years...". Averaging the 50% reduction over five years translates to an annual reduction of 10%.[1] According to the price cap mechanism, the targeted reduction to switched access rates that CALLS proposes, along with an annual inflation rate realistically assumed to be 2%, implies an X factor of 12% ($-10\% = 2\% - X$, or $X = 2\% + 10\%$). Moreover, inflation rates above 2% translate into X factors above 12%. Under the current mandated 6.5% X factor, CALLS proposes an annual 85% increase in the price cap offset.

Alternatively, the CALLS targeted 10% average annual reduction in switched access rates can be compared to the rate reduction mandated under current price caps. With a 2% inflation rate, the reduction would be 4.5% (2% – 6.5%). CALLS proposal signifies annual reductions of more than 120% above the inflation adjusted decline possible under the existing price cap mechanism.[2] The CALLS proposal to target reductions in switched access usage rates is not based on quantitative economic evidence regarding improvements in economic efficiency, promoting competition, and encouraging innovation.

Since the CALLS proposal for switched access usage rates implies an X factor significantly above that mandated by the FCC, an issue arises as to the predatory nature of the targeted price reductions. In its Memorandum of Support of the Revised Plan, page 12, footnote 13, CALLS notes that, "In the comments and replies with respect to its original proposal, no party offered any evidence to support any claim that these reductions or target rates result in predatory prices". Among economists, there is widespread agreement in principle that 1) incremental costs would be the basis for efficient price floors, and 2) incremental costs would be forward-looking, rather than historical. Notwithstanding the difficulties in measuring and defining forward-looking incremental costs, as a practical matter, cost information is required for a determination of predatory prices. The CALLS proposal does not contain the relevant cost information. It further precludes an economic evaluation of switched access usage rate floors, by proposing that incumbent local exchange carriers would no longer be required to file cost studies on February 8, 2001 (see section 3.2.8 of the Modified Universal Service and Access Reform Proposal). In order to foster competition, and advance innovation, the FCC has determined that prices for interstate access, on average, should decline by 6.5% after adjusting for inflation. Due to the extraordinary and targeted price reductions for switched access usage rates, and the paucity of (reliable) cost information, the possibility of predatory prices should not be summarily discounted.

The CALLS targeted price reductions for switched access usage rates engenders insufficient revenues. To overcome revenue deficiency, CALLS proposes three further modifications to the FCC's price cap mechanism; i) reduction of price cap offset, ii) removal of revenues from price cap basket, iii) rebalancing of rates within price caps. Each of the three proposals procures significant modifications to the current price cap mechanism, potentially conflicts with the economic principles of price cap regulation, and contradicts a stated major objective of the CALLS proposal.

First, price cap offsets are reduced in the CALLS proposal. From page 13 of the Memorandum, "As discussed below, under the revised plan, special access rates are reduced in the first year by 3.0% rather than 6.5%." The offset reduction conflicts with a crucial goal of the CALLS plan. As noted on page 11 of the Memorandum, "The productivity offset or 'X-factor,' has been the subject of extensive regulatory proceedings and litigation, and it has created significant uncertainty in the marketplace. The CALLS plan is designed to end this regulatory gridlock by adopting an X-factor of 6.5% to reach target rates for local switching and switched transport." Moreover, since the current price cap mechanism groups transport and special access services under the trunking basket, the 3% offset for special access implies that the transport offset must exceed 6.5% in the first year of the CALLS plan. Contrary to ending regulatory gridlock, the plan invites a new round of offset proceedings.

Further, the CALLS proposal contradicts the economic principles associated with price cap regulation. From section 3.2.2 of the Modified Universal Service and Access Reform Proposal, CALLS seeks the "... application of the X-factor adjustment in the price cap formula across all ... interstate price cap baskets, other than special access elements ..." In price cap regulation, offsets are applied to specific baskets. Aggregating baskets upon offset application, effectively alters, and can distort, targeted price reductions, compared to feasible rate decreases under disaggregated and mandated basket definition. Since offsets must be determined in conjunction with the services contained within a basket, redefining basket composition (e.g. aggregating baskets) is tantamount to redefining the effective offset. No evidence has been provided on the enhancement of economic efficiency, competition, and innovation through offset re-calibration, and redefining service baskets.

Second, CALLS recovers revenue from their targeted reductions in switched access usage rates through the removal of revenues from price cap baskets. Section 1.3 of the Modified Universal Service and Access Reform Proposal asserts that, "Upon implementation, ILEC USF assessments (a) are removed from existing price cap baskets ..., and (b) are not subject to the Price Cap formula in future years." Third, revenue recovery ensues from increases in subscriber line charges, as documented on page 7 of the Memorandum. These proposals are not supportable by recourse to economic principles or quantitative economic analysis. Indeed, a particularly egregious plan highlighting the targeted nature of the CALLS proposal for reductions in switched access usage rates relates to exogenous adjustments. Section 3.2.5 of the Modified Universal Service and Access Reform Proposal offers that, "After July 1, 2000, exogenous adjustments will be applied only to services other than those constituting traffic sensitive interstate access charges." However, if an adjustment is truly exogenous, economic principles dictate that it is not possible ex ante to assign adjustments to specific services. Prior assignment of adjustments is inconsistent with exogeneity.

For the reasons outlined above in this declaration, the CALLS proposal should be rejected.

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Jeffrey I. Bernstein

Endnotes

[1] The 10% average annual rate decrease excludes the July 1, 2000 $2.1 billion reduction. There is insufficient information in the proposal to determine the annual percentage decline inclusive of the one-time reduction.

[2] The previous calculations assume for simplicity that the switched access basket consists of a single service. The argument is unaffected when multiple services are considered.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Comments of Focal Communications Corporation in CC Docket No. 96-262 was sent by United States First-Class Mail, postage prepaid, or hand delivered, on this 3rd day of April, 2000 to the parties on the attached list.

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